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David S. Guzy, Chief,
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Minerals Management Service
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Dear Mr. Guzy

The City of Long Beach ("City") and the State of California ("State") hereby submit their comments to MMS's Further Supplementary Proposed Rule, on crude oil valuation, 64 ed. Reg. 73820 (December 30, 1999).

I.

General Comments

The City and State are generally supportive of the approach taken by MMS. We specifically support MMS's proposed index pricing methodology for valuing non-arm's length dispositions of federal royalty crude oil. As MMS correctly observes, there is a lack of a truly competitive market at the lease, especially in California. We agree with MMS as to the following:

(1) in general there is no price transparency at the lease or field level;

(2) in general a competitive market does not exist at the lease or field level;

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(3) exchanges or sales between affiliates are not arm's-length;

(4) the price specified in exchanges does not represent the value of the oil but only the difference in value between the oil sold and the oil purchased; and

(5) spot prices are the best indicator of the value of production and are preferable to using sales in the field or area.

We continue to maintain that spot prices should be used for all lease crude, except perhaps for small independent producers who may not have sufficient market power to sell royalty crude at its true value. Major oil companies possess sufficient market power to sell royalty crude at its true value, and so for them, index prices should be used. We recognize, however, that MMS has committed to a gross proceeds methodology for crude sold directly or indirectly on arm's length sales contracts.

We continue to support MMS's position, which has solid historical precedence, that lessees have the obligation to market lease production for the mutual benefit of the lessee and lessor and that marketing costs are not deductible expenses even if the lessee chooses to market downstream from the lease. We agree also that MMS may require that federal royalty production be valued using the index methodology if there is misconduct by or between the parties to the arm's length contract or breach of the duty to market for the mutual benefit of the lessee and the lessor. Sect. 206.102 (c) (2). We view with suspicion any attempts by federal lessees to strike provisions that would protect MMS against those lessees who act unreasonably or in bad faith in marketing federal royalty oil.

We agree with MMS's decision to close a loophole in the proposed regulations concerning possible double deductions for location differential and transportation costs.

See §206.112 (d) and (g). As we pointed out in previous comments, the earlier proposed regulations permitted the double deduction of certain transportation costs between leases and aggregation points. Present regulations provide for deductions for both location differentials and transportation costs. But location differentials in exchanges often reflect transportation costs, and thus there is a potential for double deductions. MMS is correct not to allow double deductions.

We do have some objections to the new proposed regulations. We have expressed our objections in previous submissions and will not repeat them all here. Our discussion here will be limited to the following issues:

(1) Quality and location adjustments under §206.112;

(2) Tracing arm's-length sales prices back to the lease when the sales take place after non-arm's-length sales or transfers under §206.102 (a) (2).

(3) Transportation costs under §206.113 (c);

(4) MMS's approach to overall balancing agreement and noncompetitive crude oil calls. See Comments to §206.102;

(5) Appropriateness of using ANS spot prices to value production in California and Alaska.

II

The Adjustments For Quality and Location in Section 206.112 For Oil That is Not Sold Under an Arm's-Length Contract are Unworkable

The most serious problem with the current proposal concerns the quality and location adjustments. Section 206.103 requires that §206.112 be used to make quality and location adjustments to the index prices when crude is not sold under an arm's-length contract. Section 206.112 will probably have to be used also for the location and quality adjustments referenced in §206.102 (d) (1) (i) for crude sold under arm's-length contracts under certain circumstances; for example, if a lessee transfers crude to an affiliate and the affiliate sells a common stream which differs in quality and location from the lease crude. We agree that adjustments to lease crudes should be made when they differ in quality and location from index crudes. Our basic objection to Section 206.112 is that it is unclear and indeed unworkable in many instances and will lead to lessees either making adjustments for quality and location which are larger than they should be or requesting special value determinations under §206.107 .

A. Quality Adjustments

An example used in §206.112 (a) (iii) clearly illustrates one of the problems. Under this example, if a lessee produces 100 barrels and exchanges that 100 barrels three successive times under arm's-length agreements to obtain oil at a final destination, the lessee should total the three adjustments from the exchanges to determine the adjustments. This example produces the wrong result. Suppose a producer in California produces 100 barrels of fifteen degree crude, enters into three successive exchanges each for 100 barrels and ends up with 100 barrels of twenty degree crude at its Los Angeles refinery. The quality adjustments in the three exchanges will adjust fifteen degree crude to twenty degree crude, but will obviously not account for the difference in quality between the twenty degree crude and ANS (a 27° crude). Section 102.103 provides that 206.112 is to be used to make the appropriate quality adjustments between lease crude and an index crude. But §206.112 (a) (iii) does not fulfill that function. It adjusts for the difference in quality of the crude ultimately received on exchange for the lease crude but does not adjust for the difference in quality between the lease crude and the index crude.

This example is illustrative of the general problem of the quality adjustments under §206.112. The quality adjustments in exchanges will accurately reflect the difference in quality between the lease crude and the index crude only when the lease crude is exchanged for the index crude.

The problem is compounded by the fact that crudes differ in sulfur content as well as gravity and thus quality adjustments in exchanges contain elements of both. This further complicates the usefulness of quality adjustments in exchange agreements to adjust the quality of lease crude to the quality of an index crude.

Suppose a federal lessee of California OCS crude enters into an exchange agreement for Midway Sunset crude. The OCS crude differs both in gravity and sulfur content from Midway Sunset crude and so any quality differential in the exchange would account for both gravity and sulfur differences in the two crudes. The quality differential in the exchange will not likely provide any detail as to how much of the differential is attributable to gravity and how much is attributable to sulfur. ANS also differs in quality and sulfur content from both OCS and Midway Sunset. Thus the quality differential in the OCS/Midway Sunset exchange will provide no guidance in making a quality adjustment between OCS and ANS.

In these instances where the federal royalty crude is not exchanged for an index crude, we again propose using the gravity and sulfur banks used in common carrier pipelines as the basis for making quality adjustment. The All American Pipeline carries OCS crude oil and has adjustments for gravity and sulfur. Those can be used to adjust the quality of OCS to the quality of ANS. Other pipelines in California are common carriers and some have gravity and/or sulfur banks which can be used to adjust the quality of federal royalty crudes produced in California to the quality of ANS.

In summary, the use of quality adjustments in arm's-length exchange agreements to make the adjustments called for in §206.112 (a) should be limited to those instances where the royalty oil is exchanged for an index crude. Otherwise quality adjustments in common carrier pipeline tariffs should be used.

(B) Location Adjustments

We agree with MMS that location differentials in exchanges can be used to adjust lease crude to an index crude, but only in those instances where a producer uses exchanges to move lease crude to market center. So for example, if the three successive exchanges described in §206.112 (a) (iii) move lease crude to a market center, then the location differentials in these exchanges could be used to make the appropriate location adjustment. We assume in this example that location and quality adjustments have not been combined in the exchange into one differential

If, in addition to location differentials in exchanges, a producer incurs transportation costs, the actual transportation costs should be deducted also, provided that there is no double counting of the cost to transport the lease crude to market.

Location adjustments in exchanges involving crudes in totally different markets will not be helpful in making the appropriate adjustment to the lease crude. For example, suppose California OCS crude is exchanged for West Texas Intermediate crude. The location differential in such an exchange will not indicate the appropriate location adjustment for the OCS crude, because the appropriate location differential should reflect the cost to move the OCS crude to a market center for ANS. In such a situation, instead of using the location differentials in these types of exchanges, the lessee should use actual transportation costs for other OCS production or the location differentials in other exchanges used to move OCS to an ANS market center. If the lessee does not move any lease crude to a market center, MMS should determine the appropriate location differential. See §206.11a (h) (i) (2). MMS could rely on location differentials reported for movement of similar lease crude to market centers or the cost method under §206.111.

C. Section 206.112 (b)

Sections 206.112 (a) and (b) provide for location and quality adjustments for royalty crude disposed of in arm's-length and non-arm's length exchange agreements respectively. Section 206.112 does not provide for situations in which royalty crude is moved directly from leases to refineries without being exchanged. MMS will still have to decide the appropriate quality adjustments. We suggest amending Section 206.112 (b) to include royalty crude not disposed of in exchange agreements.

III.

The Calculation of the Royalty Value for the Sale Of Oil After a Sale or Transfer Under a Non-Arm's-Length Contract Is Subject to Unsolvable Tracing Problems

Section 206.102 (a) (2) permits the use of the gross proceeds methodology even after royalty crude is sold or transferred on non-arm's-length contracts. We continue to be very concerned about tracing royalty crude through multiple exchanges. We have addressed this problem several times before in previous submissions and do not believe MMS has adequately appreciated or addressed the problem.

When royalty crude oil is sold or transferred under a non-arm's-length contract, it often is commingled with other crudes. Once the royalty crude is commingled, it is often impossible to trace the royalty crude to some specific outright sale except in those rare occasions in which all the commingled stream is sold under a single contract. Suppose 100 barrels of lease oil are exchanged for 100 barrels of a commingled stream involving thousands of barrels of crude. The lessee might enter into many contracts for the sale of the commingled stream. The problem this raises for royalty crude valuation is that the current proposal permits the lessee to report the lowest sales price he receives for any portion of the commingled stream.

To rectify the problem, we propose that (1) the sales price of the commingled stream be reported if all of the commingled stream is sold under one contract, and (2) the royalty crude be valued at the weighted average sales price of the commingled stream, if the commingled stream is sold under multiple contracts.

The tracing problem is further compounded if the lessee enters into exchanges for the commingled stream which it has received on exchange for the lease crude. If all of the lessee's crude is a commingled stream and is exchanged for one other crude, then it is fairly easy to trace the lease crude. (See the example discussed above of three successive exchanges of 100 barrels of crude.) If, however, in the more likely event, the lessee exchanges the commingled stream on multiple exchanges, each containing more than the volume of crude produced on the federal lease, it will be impossible to trace the lease crude through those multiple exchanges. To rectify this problem, we propose the following with respect to situations where the lessee obtains a commingled stream on exchange for the royalty crude:

(1) If the lessee enters into only one exchange for all the commingled stream, then he will not be precluded thereby from tracing the lease crude to an outright sale;

(2) If the lessee enters into multiple exchanges for the commingled stream and more than one of these exchanges have volumes equal to or greater than the volume of the lease crude, then he must use §206.103 to value his crude.

IV.

The Cost to Transport Crude Beyond Market Centers to Alternate Disposition Points Should Not Be Deductible

We continue to be opposed to a deduction for transportation costs to alternate disposal points which are further away from the lease than are the market centers for the index crudes. Under Section 206.113 a producer of OCS crudes in California could deduct the entire cost of transporting it to the Gulf Coast, even though in so doing he would be bypassing the California market centers for ANS crude oil. Similarly, a producer of Permian Basin crude in New Mexico could deduct the entire cost of transporting that crude to Midwest refineries even though the producer would be bypassing Midland, Texas and Cushing, Oklahoma.

The MMS's regulations are designed to ascertain the value of royalty crude at the lease. We agree that if lease crude is sold at a market center or valued using on index crude, it is appropriate in determining value at the lease to subtract an amount equal to the cost of moving the lease crude to a market center. Our objection to permitting a producer to bypass a market center and still deduct the entire cost of transportation is that the royalty oil at the lease is valued less than the lease for purposes of royalties other than its market value. The additional cost of transporting the crude past the market center to the alternate disposition point should not be allowed.

In most, if not all, instances where the lessee transports or enters into exchanges for the delivery of crude to an alternative disposition point, a lessee can still apply the location differential from the lease to a market center. For example, if one company decides to transport California OCS crude to the Gulf Coast and thereby bypasses California market centers, the appropriate transportation deduction will be readily ascertainable from transportation costs reported by other OCS producers. Section 206.102 (b) provides that to MMS will provide the appropriate adjustments to location and quality adjustments for crude exchanged on non-arm's length transactions. So too with respect to transportation costs of crude transported past market centers, MMS can supply the appropriate transportation deductions based on the transportation costs reported by producers who transport crude from those leases to market centers.

V.

The Regulations Should Require That Lessees Inform MMS if it Has Overall Balancing Agreements with any of the Companies to Which It Has Sales of Royalty Crude Oil

We continue to be surprised and disappointed that MMS does not require federal lessees to inform MMS when it has an overall balancing agreement with the companies to which it has sales of royalty crudes.

When companies have overall balancing agreements with other companies, even their apparently outright sales to each other are not arm's-length. If companies A and B have an overall balancing agreement, company A's outright sales to Company B are balanced by corresponding outright sales by Company B to Company A even though individual sales contracts by the two companies might not reference the reciprocal nature of these sales. The overall balancing agreement effectively treat so called outright sales as part of a large exchange. MMS correctly observes in its current proposal: "In a buy-sell exchange, the parties may state any lease price they wish, because their primary concern is the difference in value between the oil sold and the oil purchased." These observations apply with equal force to so called "outright" sales when they are subject to an overall balancing agreement. Company A can sell its crude in an outright sale to B at a price below market value, if it knows that Company B will sell another crude to Company A at a price below market value. Company A and Company B are kept while in their outright sales to one another if the pricing provisions in the two outright sales reflect the relative difference in values between the two crudes sold.

We vehemently disagree with MMS's decision to await audits to reveal the existence of overall balancing agreements. The very need to conduct an audit would be triggered by the knowledge that a lessee's seemingly outright sales of royalty crude were subject to an overall balancing agreement. Federal lessees should be required to inform MMS as to those companies it sells royalty crude, which of them have an overall balancing agreement with the federal lessee. Such a requirement is not the least burdensome.

VI.

The Regulations Should Require That Lessees Inform MMS If Their Lease Crude Is Subject to a Call.

Lessees should be required to inform MMS if their lease crude is subject to a call. Although some lessees may still be able on occasion to obtain market value in sales of lease crude to a company that has a call on that crude, many lessees will not. MMS should require lessees to inform MMS about lease crude subject to a call so that MMS can make an informed decision as to whether to audit such lessees. Such a request does not place any burden on the lessee.

VI.

The Recent Decision in the Long Beach Case Does Not Undermine the Validity of Using ANS Crude as Basis for Determining the Market Value of Production in California or Alaska

In the recent trial, Exxon was permitted to argue to the jury, over Long Beach's objection, that the oil companies who posted had no duty to post a market value price. Exxon also argued to the jury that the contracts under which Long Beach sold crude to the oil companies prevented Long Beach from using any crude oil not produced in the Wilmington Field and three nearby fields. Exxon then argued that the contracts prevented Long Beach from relying on the spot price of ANS to value Long Beach's crude oil.

Having made that argument, Exxon may not now claim that the verdict of twelve jurors in Los Angeles prevents MMS from using the spot prices of ANS to determine the value of production in California. MMS obviously has no contractual provisions which prevent it from using the spot prices of ANS as a benchmark for California an Alaska production, and significant evidence produced in the course of that litigation demonstrated that the oil companies marked California oil in reference to the value of ANS.

We hope that these comments are helpful.

Very Truly Yours,

James N. McCabe
Deputy City Attorney
City of Long Beach